



TESTIMONY
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SUB-COMMITTEE ON INVESTIGATIONS AND
OVERSIGHT COMMITTEE ON SMALL BUSINESS,
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Chairman Altmire and all of the members of the sub-committee: thank you for this opportunity to speak at this hearing on behalf of my colleagues who invest in start-ups and early stage businesses. I took the liberty to title my discussion today: "Entrepreneurs Can Lead Us Out of the Crisis".

Before I elaborate on the title, please allow me to explain my companies, BlueTree Capital Group and BlueTree Allied Angels. BlueTree Capital Group was created as an entity to purposefully aggregate angel investors to invest in early stage companies. We are a member of the Angel Capital Association, our professional support organization, whose testimony you have heard today from John May.

Because BlueTree is located in Pittsburgh, PA, we are fortunate to be strengthened by 3 outstanding Universities that serve as very fertile ground for multiple 'spin-out' of ideas into companies. Please do not confuse us with Silicon Valley, Boston, or San Diego. We are a mid-west town with a very small but vital venture capital presence – the companies created in Pittsburgh are less likely to be funded by the VCs or even by the super-rich angels like Mark Andreessen (founder of Netscape), John Doerr (Intel executive and Venture Capitalist), or Jeff Bezos (Amazon founder),.....but instead they are funded on the backs of hard-working professionals whose average annual salary is between \$200,000 and \$400,000. I tell you this, because most angel investors in the US look like us, not like Mark Andreessen, John Doerr, or Jeff Bezos whose multiple millions (\$\$) lead people to think that they can invest in start-ups under

any circumstances and in any economic climate. The average angel investor in the US is at the lower end of the wealth spectrum and is not located in Silicon Valley or Boston.

This is an important distinction for the committee -- the current economic crisis has crippled the average angel investor's ability to invest because their net worth has dropped to a point where they no longer can place discretionary/marginal capital "at risk" on start-up companies. According to the Spectrum Group, a research consultancy group, affluent households with \$500,000 or more in net worth declined by 28% last year. At BlueTree Allied Angels, since September 2008, 2/3 of our 53 investors have ceased investing in early stage companies.

Why should this matter? – After all, these are affluent people who can likely weather a tough economy. That is surely true in most cases for them personally, but their financial ability to invest has been severely curtailed.

It matters because they fund companies that banks or other sources of capital will not or cannot fund.

It matters because these investors are "the mechanism" that fills the funding gap between friends/family (or credit cards) and institutional financing. Without this mechanism there would be no Alcoa today. Alcoa was funded by 2 angel investors in 1907 in the Pittsburgh region. (*Alcoa founder and patent holder, Charles Martin Hall; he moved from Oberlin, OH to Pittsburgh because 2 Pittsburgh angel investors believed in Hall's idea.*)

It matters because entrepreneurs are the fertile soil for job growth and recovery. We want Americans to fill the thousands of jobs a healthy growing economy can create.

It matters because funding entrepreneurs can lead us out of the economic crisis.

This recessionary crisis is more than a downturn caused by bad lending practices and Wall Street avarice. A greater underlying dynamic is at work and has been at work for some time —a fundamental change is taking place in the global marketplace –it is a **rapidly changing, 'technology-driven' global economy**. The United States, the nation that brought the world electricity, the telephone, radio, TV, and the personal computer, could be losing the race for its own history. China, Germany, and other countries are aggressively encouraging and setting the stage for an economy that will flourish in this new 'technology-driven' age – For example, contrast the US 15% capital gains tax rate to the 0% capital rate in Hong Kong, Singapore, and even Germany. The current U.S. Economy and its tax policies are not built for this rapidly changing technology-driven new world. In addition to fixing our debt and credit infrastructure, the US needs a healthy **"equity capital infrastructure"** that can rapidly respond to the demands of a new age and the new competitive forces of the world. The real danger for the US lies in merely fixing the old economy and ignoring the new economy.

Only entrepreneurs have the flexibility, the freedom and the risk-everything ambition to find the path back to prosperity – and it is the passion and commitment of angel investors funding these entrepreneurs that makes it possible. Yes, passion and commitment. About half of the angel investors provide more than money to entrepreneurs. They provide experience, guidance, business consulting, and contacts from their Rolodex for customer introductions or vendor/supplier relationships; for

example, one of our investors is a retired CFO and he provides financial strategy consulting for our some of our portfolio companies. Another one of our investors helps companies with their supply-chain strategy; and for a BlueTree portfolio IT company, several of our BlueTree investors provided multiple leads for customers.

The passion and commitment also exists in tolerating investment losses. Like our venture capital friends, in an average angel investor portfolio of 18 companies, the angel investor will see 5 of those companies go bankrupt and only 1 or 2 will deliver an outstanding return. It might be better explained metaphorically: 5 will strike out, 10 will make it to first or second base and return a moderate amount of capital to investors, and 1, maybe 2, will be a Hank Aaron home run.

Let's think about the home-runs for a minute – in the best companies that appeared in the past 30 years. Google, Microsoft, Apple, or even any of the wireless providers (*In Pittsburgh, the home runs are companies like Respirationics, Fore Systems, McKesson Automation*) – EACH OF THESE burst onto the scene because someone, or some group of people, decided to invest in an idea before it was a product. Those early investments funded innovation. They funded growth. They created jobs, and they changed the world. Those investors are the angels we are losing today.

The hidden cost of this economic crisis is that angels have lost their wings. They are retracting as a result of the weak market and a stymied economy.

I greatly appreciate the opportunity to speak with you today because as policymakers, you can make a difference by setting a tone with legislative initiatives that can help reverse the downward spiral of investing in business building and job growth. Regardless of where we fall on the political spectrum, all of us in this room have to agree that innovation and building businesses are imperative elements of American economic strength.

There have been recent policy initiatives to restore our national communications and travel infrastructure, but that infrastructure has no value unless we restore the “financial infrastructure” for building sustainable companies. Nice new bridges don't mean a thing unless we are creating sustainable jobs whose tax base can pay for the nice new bridges.

If capital does not start flowing soon to start-ups and early stage businesses in this country, we will be faced with years of lost innovation. We will lose the good paying jobs and the good healthy tax base to other parts of the world that are aggressively facilitating innovation and start-up companies.

Please consider the following suggestions for leading the direction in restoring our country's funding infrastructure and helping our Entrepreneurs lead us out of crisis.

1. Repeal the Capital Gains Tax OR Change the Capital Gains rate to be something significantly lower than the current rate. Perhaps a 0% capital gains rate when having made the investment in any year in which the company had earned less than \$100,000 in annual revenues. Then a 5% capital gains when having invested in any year in which the company earned between \$100,000 and \$500,000. Then 10% for \$500,000 to \$1,000,000 and 15% across the board for the rest. This

would be a middle of the road solution if a match to the 0% of Hong Kong, Singapore, and Germany was unattainable by Congress.

By changing the capital gains rate, policy makers can encourage angel investors (and venture capital) to get back into the game of building companies and risking their capital to find that 1 in 18 companies that can be the next Hank Aaron home run.

This also sets the tone that America is serious about not losing our history of innovation to China or any other part of the world.

2. Do not treat us or our venture capital partners like Private Equity Funds or Hedge Funds. Unlike traditional PE Funds, we don't FLIP companies in 3 years or strip out their value – INSTEAD, we build value; we build companies by nurturing them over 6 – 12 years. The average holding period for a portfolio start-up company that exits via a merger or acquisition is ~6.5 years and via an IPO is ~8.3 years (*Price Waterhouse Coopers/Thompson Reuters*). The recession will undoubtedly lengthen this average holding period.

Some angel investor groups create a small venture fund to invest in early stage companies; the carried interest for managing these small funds is miniscule because the fund size is small. And the carried interest “holds a manager's feet to the fire” to ensure a successful outcome === it encourages results and supports the patience required to build companies over a 6 to 12 year time frame.

Please don't discourage the investment behavior by increasing capital gains rates for us or our venture partners who co-invest in many of our portfolio companies.

3. Change the tax for “warrants” to be treated as capital gains instead of ordinary income. Many early stage companies lack the data to set an equity price for their company. As a result, they offer investment opportunity via a debt instrument instead of an equity instrument. Warrants added to the debt instrument can help attract the vital and necessary risk capital to get a company started -- it can be an extra reward for the earliest risk takers (aka, first round of investors who take the biggest risk) – taxing as capital gains would encourage more investors to engage in taking the earliest risk.
4. Policy makers can create state innovation funds and programs – put money into the “investment infrastructure” by allocating money to states to match angel investor funds that focus on investing in start-ups. The term “Start-ups” will likely need to be well-defined. Require the replenishment of the original capital when certain benchmarks are achieved; then begin the cycle again by deploying the returned capital in another fund.
5. Help breed sophisticated and educated angel investors via an education program. There are numerous individuals who would invest in building companies if they understood the value and

the process. Federal funds could be allocated to professional support organizations like the ACA (Angel Capital Association) and the ACEF (Angel Capital Education Foundation) to expand educational resources. These organizations focus on supporting best practices and encouraging co-investing among sophisticated investors in order to better facilitate the growth of companies.

6. Reduce the burden of Sarbanes-Oxley compliance. The cost for taking a company to the public markets has become prohibitive. Companies need to be harvested so new crops of companies can be planted. Sarbanes-Oxley impedes the harvesting process and is punishing the 98.9% who are law-abiding responsible companies applying good accounting and legal practices. The **business building system and infrastructure** needs an economically healthy ability to harvest its companies to create new wealth that will then be re-planted (re-invested) in a whole new crop of companies.

Thank you for considering these opportunities to restore our economy.